

Overview of Key U.S. Compliance Issues for International Banks

2014 IIB/CSBS U.S. Regulatory/Compliance Orientation Program

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What is Compliance and Why is it Important?

Compliance Overview

- Compliance with U.S. laws, regulations and policies, and increasingly, codes of conduct and similar standards that apply to a foreign bank's business activities and operations
- Key focus by U.S. banking regulators, especially as part of overall risk management program
 - See SR 08-8/CA 08-11, *Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles* (supervisory guidance to clarify FRB views on compliance risk, focusing primarily on firm-wide compliance risk management for large banking organizations with complex compliance profiles, including FBOs), October 16, 2008
 - See Speech by Mark W. Olsen, FRB Governor, *Compliance Risk Management in a Diversified Environment*, May 16, 2006
 - See Paper by Basel Committee on Banking Supervision, *Compliance and the compliance function in banks*, April 2005; see also follow-up survey: *Implementation of the Compliance Principles: A Survey*, August 2008
 - See Speech by Carolyn DuChene, Deputy Comptroller for Operational Risk, *Operational Risk*, March 27, 2014
 - See Consultative Paper by Basel Committee on Banking Supervision, *Principles for enhancing corporate governance*, October 2014
 - See Speech by Daniel K. Tarullo, FRB Governor, *Good Compliance, Not Mere Compliance*, October 20, 2014
 - See Speech by William C. Dudley, FRBNY President, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*, October 20, 2014
- Noncompliance also presents legal, economic, and reputational risks

Compliance Overview (cont'd)

- Risk of significant enforcement actions/penalties
 - Criminal charges and \$8.9 billion in fines assessed by the New York Department of Financial Services (NYDFS), New York County DA (NYCDA), OFAC, DOJ, and Federal Reserve for violations of OFAC sanctions (2014) (BNPP)
 - Criminal charges and \$2.8 billion in fines assessed by the DOJ, Fed, NYDFS, and SEC for conspiring to aid tax evasion and providing unregistered brokerage and investment advisory services (2014) (Credit Suisse)
 - \$1.9 billion penalty assessed by the FHFA for violating federal and state securities laws in connection with private-label mortgage-backed securities (2013) (Deutsche Bank)
 - \$453 million in fines and penalties assessed by the FERC for manipulation of energy trading markets (2013) (Barclays)
 - Criminal charges and \$1.5 billion in fines and penalties assessed by the DOJ, CFTC, Finma, and FSA for manipulation of LIBOR rates (2012) (UBS)
 - Criminal charges and \$1.9 billion in fines and penalties assessed by the DOJ, OCC, OFAC, NYCDA, Federal Reserve, and FinCEN for an ineffective compliance program that failed to identify or prevent money laundering (2012) (HSBC)
 - \$667 million in fines and penalties assessed against a foreign bank by the NYDFS, NYCDA, Treasury, DOJ, and Federal Reserve for stripping origination data from transactions that originated with Iranian clients (2012) (Standard Chartered)

Compliance Overview (cont'd)

- Stakes keep getting higher, and maintaining compliance keeps getting harder
 - Larger, more complex organizations/multiple lines of business (e.g., banking, securities, insurance each with own regulatory regime)
 - More cross-border issues and activities: multiple jurisdictions and laws often inconsistent
 - More and more laws and standards (e.g., Dodd-Frank)
- Important to Basel II/III regime
 - Compliance risk closely tied to operational risk/fraud which is component of capital requirements

What are some of the key considerations for establishing an effective compliance program?

Compliance Program

- Compliance policies, procedures and structure should be based on the size, risk profile, and scope/structure of U.S. offices and activities
 - FBOs with over \$50 billion in total U.S. third-party assets, and operating through multiple legal entities, should implement a U.S. operations-wide risk management program, with a dedicated corporate compliance function that reports directly to the governing body or an appropriate committee of the governing body
 - Smaller FBOs and large FBOs with relatively limited range of activities/entities can rely on less formal measures such as GC or Management Committee
 - FBOs with U.S. operations should have a local compliance program that is specifically designed to ensure compliance with U.S. laws
 - FBOs with over \$10 billion in total global assets must comply with risk management requirements that vary based on the institution's size in the U.S. and globally (Dodd-Frank Section 165 enhanced prudential standards)
 - FBOs have flexibility to work within head office's existing compliance oversight structure
- Pay attention to regulatory and litigation trends and priorities
 - *E.g.*, industry conferences, speeches/testimony, enforcement actions

Compliance Program (cont'd)

- Regulators look for board/senior management oversight and tone-setting; proper identification and measurement of key risks; effective vertical and horizontal communication and monitoring and reporting of risks within the organization; appropriate policies and procedures
 - But also need training and independent testing (e.g., internal audit)
- Communication with/involvement of head office is important
 - Increased focus on enterprise-wide compliance risk management
 - Extraterritorial nature of many aspects of U.S. law/regulation (e.g., BHCA nonbanking prohibitions; AML/OFAC; Dodd-Frank, especially derivatives provisions and the Volcker Rule; U.S. securities and tax laws)

Compliance Program (cont'd)

- Consider and clarify relationships of compliance function to business lines, head office counterparts, legal, internal audit
 - *E.g.*, compliance staff independence from business lines a key objective
 - Centralized compliance function; or
 - If compliance is integrated with business lines, regulators will expect several features designed to ensure independence:
 - Dual reporting line for embedded compliance personnel to corporate compliance function outside of business unit
 - Personnel decisions and resolution of compliance matters should not be decided by business unit
 - Compensation and evaluations of compliance staff should not be tied to business line performance
 - Embedded compliance personnel should focus purely on compliance

Compliance Program (cont'd)

- Regulators increasingly expect larger banks to separate their compliance and legal functions
- Dodd-Frank Section 165 enhanced prudential standards:
 - Risk committees for U.S. risk management and limited stress testing requirements for public FBOs with at least \$10B in global assets and all FBOs with \$50B in global assets
 - U.S. chief risk officer reporting to risk committee for FBOs with at least \$50B in US assets
 - Intermediate holding company structure for FBOs with at least \$50B in US non-branch assets
- Stature of compliance function within the organization also important
 - Head of compliance as member of senior management
 - Direct report to CEO, audit committee, or similar function
 - Ability to access information throughout the organization

What are some of the key
compliance issues for
FBOs?

BHCA Compliance Issues

General

- A BHC is a company that “controls” a bank
 - Control over a bank is defined as owning or controlling 25 percent or more of any class of the bank’s voting securities, having the power to select a majority of its board of directors or otherwise exercise a controlling influence over its management
 - Concept of control is complex and relevant in many contexts under BHCA
 - Requires aggregation of holdings across the organization
- Foreign banks that have U.S. branches or agencies but do not have U.S. bank subsidiaries are not BHCs, but are treated like BHCs for most purposes

BHCA Compliance Issues

Section 3 of the BHCA

- Requires prior FRB approval for foreign bank acquisitions of 5% or more of voting securities of a U.S. bank or BHC
- Also applies to acquisitions of interests in foreign banks that have U.S. bank subsidiaries
- Although prior FRB approval is required for the acquisition of a U.S. federal savings association under Section 4 of the BHCA (because it is not a “bank” for purposes of the BHCA), the regulatory application is reviewed and processed much like a bank application under Section 3 of the BHCA, and also requires approval from the OCC under separate statutory thrift regime

BHCA Compliance Issues

Section 4 of the BHCA

- Section 4 of the BHCA restricts the nonbanking activities and investments of BHCs and foreign banks with U.S. branches and agencies
- All (i.e., worldwide) nonbanking activities and investments are prohibited unless an exemption exists
- Also applies to companies (but not individuals or governments) controlling the foreign bank
- Requires aggregation across the organization
- Volcker Rule, which applies to foreign banks with U.S. banking operations and their affiliates, raises similar issues

BHCA Compliance Issues

Section 4 of the BHCA (cont'd)

- Key Exemptions Under Section 4 of the BHCA
 - General Exemptions (some require applications/notice; many are self-executing)
 - Closely Related to Banking – BHCA Section 4(c)(8); 12 CFR 225.28 (e.g., lending, securities brokerage/private placement, trust and advisory activities, leasing, derivatives)
 - Servicing Activities – Section 4(c)(1)(C); 12 CFR 225.22(b) (acting as agent for U.S. branches and other affiliates in providing services to third parties; and internal services for affiliates)
 - Noncontrolling Investments – Section 4(c)(6); 12 CFR 225.22(d)(5) (e.g., less than 5% “passive” investments)
 - Financial in Nature and Complementary Thereto – (financial holding company (FHC) status required) BHCA Section 4(k); 12 CFR 225.81 et seq (e.g., energy trading)
 - Fiduciary holdings – BHCA Section 4(c)(4); 12 CFR 225.22(d)(3)
 - Shares/assets acquired pursuant to loan workouts or foreclosures – Section 4(c)(2); 12 CFR 225.22(d)(1)

BHCA Compliance Issues

Section 4 of the BHCA (cont'd)

- Special exemptions for foreign banks that are Qualified Foreign Banking Organizations (QFBOs)-- BHCA Sections 2(h)(2) and 4(c)(9); Regulation K (12 CFR 211.23)
 - Blanket exemption for all activities outside the United States, including investments in non-U.S. companies with no U.S. “activities;”
 - “U.S. activities” in this context generally means having a direct U.S. office or U.S. subsidiary
 - Also permits U.S. activities that are “incidental” to international banking activities;
 - Permits investments in non-U.S. companies that conduct activities in the U.S., subject to certain complex conditions and limitations
 - A QFBO is a foreign banking organization with (i) more than half of its worldwide business in banking (disregarding its United States banking business) as opposed to nonbanking, and (ii) more than half of its banking business outside the United States

BHCA Compliance Issues

Some Practical Compliance Considerations

- Requirement to aggregate/monitor holdings across the organization makes compliance difficult
 - *E.g.*, venture capital investment in non-U.S. company which decides to establish a U.S. subsidiary
 - *E.g.*, independent but 25% owned subsidiary of a foreign bank seeks to establish operations in the U.S. without realizing that FRB notice/approval is required
- Need to implement organization-wide reporting/screening procedures to review proposed investments that “touch” the U.S.
- Volcker Rule compliance efforts are leading to the discovery of a need to enhance broader BHCA compliance policies
- Merchant banking activities initiated after 2001 authorization may be reaching 10/15 year holding period limits

Cross-border Private Banking and Securities Services for U.S. Residents

- U.S. tax law risks of serving undeclared U.S. customers
- U.S. securities law risks of providing securities transactional services or investment advice
 - Use of “U.S. jurisdictional means” (*e.g.*, U.S. mail, telephone, facsimile machine, e-mail) triggers registration requirement in absence of exemption
- Recent developments
 - UBS case and aftermath – 2013 US-Swiss Joint Statement
 - 2014 Credit Suisse criminal conviction
 - FATCA
 - NRA interest reporting obligation
 - SEC developments – 2014 Credit Suisse action and prior actions involving Portuguese, Indian and Dutch banks
 - IRS Offshore Voluntary Disclosure Programs – 45,000+ enrolled
 - Tax treaties

Affiliate Transactions

- FRB’s Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act, imposes restrictions on extensions of credit and other “covered transactions” between U.S. banks and their affiliates, including U.S. banks that are owned by foreign banks
- Regulation W also applies to “covered transactions” between a U.S. branch or agency of a foreign bank and affiliates of the branch or agency engaged directly in FHC activities the United States, including the following activities:
 - Securities underwriting and dealing;
 - Non-credit-related insurance underwriting;
 - Merchant banking;
 - Insurance company investments; and
 - Certain transactions resulting in credit exposure to the affiliate.

Affiliate Transactions (cont'd)

- Regulation W also applies to transactions between a U.S. branch or agency of a foreign bank and any portfolio company controlled by the foreign bank under merchant banking or insurance company investment authorities
- Regulation W does not apply to transactions between a U.S. branch or agency of a foreign bank and other affiliates or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates
- Dodd-Frank sections 608 and 609 tightened Sections 23A and 23B
 - Effective July 21, 2012
 - Regulation W implementing regulations to come

Anti-Tying

- The anti-tying prohibitions of section 106 of the Bank Holding Company Act Amendments of 1970 apply to U.S. branches and agencies of foreign banks
- Section 106 generally prohibits conditioning the availability or price of one product or service (the “tying” product) on a requirement that the customer obtain another product or service (the “tied” product) from the U.S. branch or agency or an affiliate of the U.S. branch or agency
- Exceptions are available for:
 - Traditional bank products, such as a loan, discount, deposit or trust service
 - Foreign transactions, i.e., with non-U.S. persons
 - Discounts for combined products

Regulatory Reporting Requirements

- FBOs that have a U.S. banking presence (i.e., not just a representative office) are required to file certain regulatory reports, including the following:
 - Annual Report of Foreign Banking Organizations (FR Y-7) – financial statements, organization charts, shareholder information, QFBO calculation (annual)
 - Capital and Asset Report for Foreign Banking Organizations (FR Y-7Q) – reports capital and asset components of regulatory capital ratios
 - Recent changes require quarterly reporting by any FBO with total consolidated assets greater than \$50B, not just FBOs that have elected to become FHCs
 - New items designed to implement various Dodd-Frank/Section 165 standards (e.g., assets of combined US operations, Basel III certification, etc.)
 - Report of Changes in Organizational Structure (FR Y-10) – reports investments in U.S. companies and other organizational structure changes (event driven; 30 days)
 - Financial Statements of U.S. Nonbank Subsidiaries Held by Foreign Banking Organizations (FR Y-7N/FR Y-7NS) – reports financial information for U.S. nonbank subsidiaries (quarterly or annually, with frequency and detail depending on asset size)
 - FFIEC 002 – “call report” providing detailed financial information for U.S. branches and agencies (quarterly)

Outsourcing/Third Party Arrangements

- FBOs use consultants and other third-party providers for one-off projects (e.g., investigations/reviews) and continuing engagements (e.g., outsourcing business processes and technology)
- Regulatory scrutiny of these relationships has increased, including in particular payment processing, sales of ancillary consumer products and services (e.g., credit protection and credit monitoring) by third party vendors, and consulting arrangements
 - FFIEC, *Implementation of Interagency Programs for the Supervision of Technology Service Providers*, (Oct. 2012)
 - OCC Bulletin 2013-29, *Third-Party Relationships: Risk Management Guidance*, (Oct. 2013)
 - OCC Bulletin 2013-33, *Use and Review of Independent Consultants in Enforcement*, (Nov. 2013)
 - NY DFS settlement with PwC (Aug. 2014)
 - \$25 million penalty and 24 month suspension from consulting for NYS-regulated financial institutions
 - NY DFS settlement with Deloitte (June 2013)
 - \$10 million penalty and a 12 month suspension

Other Current Topics in Regulatory Compliance

- Bank Secrecy Act/Anti-Money Laundering (covered elsewhere)
 - Revised proposal for Customer Due Diligence requirements for banks (July 2014)
- Office of Foreign Assets Control (OFAC) Sanctions (covered elsewhere)
- Dodd-Frank Wall Street Reform and Consumer Protection Act
 - Consumer Financial Protection Bureau, swap push-out requirements, derivatives regulation, Volcker Rule prohibitions, Collins Amendment capital requirements, private investment adviser registration, Section 165 enhanced prudential standards, foreign remittances, resolution planning implementation
- Foreign Corrupt Practices Act of 1977 (FCPA)
 - FCPA addresses corporate slush funds, illegal campaign contributions and international bribery (applies to foreign companies with American Depositary Receipts or other securities listed on U.S. exchanges)
 - DOJ/SEC guidance issued on November 14, 2012
 - SEC anti-bribery investigation of JPMorgan's Asian hiring practices announced in August 2013

Other Current Topics in Regulatory Compliance (cont'd)

- New Home Mortgage Rules

- Regulations X and Z Amendments to mortgage servicer obligations (78 Fed. Reg. 10696 (effective Jan. 10, 2014)) and home ownership counseling and high-cost mortgages (78 Fed. Reg. 6856 (effective Jan. 10, 2014))
- Regulation Z Amendments to loan origination compensation (78 Fed. Reg. 11280 (effective June 1, 2013 (section 1026.36(h)) and Jan. 10, 2014 (remainder))), ability-to-repay and qualified mortgages (78 Fed. Reg. 6408 (effective Jan. 10, 2014)), escrow requirements (78 Fed. Reg. 4726 (effective June 1, 2013)), and higher-price mortgage appraisals (78 Fed. Reg. 10368 (effective Jan. 18, 2014))
- Amendments to implement integrated mortgage disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z) (78 Fed. Reg. 79730 (effective Aug. 1, 2015))
- Proposed amendments to the reporting requirements under the Home Mortgage Disclosure Act (Regulation C) (79 Fed. Reg. 51731 (published Aug. 29, 2014))

- Privacy/Data Security

- Treatment of nonpublic personal information about individuals who obtain financial products or services primarily for personal, family, or household purposes; Protection of customer data against intrusion
- Executive Order 13636, Improving Critical Infrastructure Cybersecurity (Feb. 2013) / NIST Cyber Security Framework (Nov. 2013)
 - NY DFS consideration of more robust cybersecurity rules for NYS-chartered banks
- CFPB amendment to the annual privacy notice requirement under the Gramm-Leach-Bliley Act (Regulation P) (issued Oct. 17, 2014)